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Lay of the Land: Recovery will start in the center, slowly

By MATTHEW GARDNER
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Where were we, where are we now and where are we headed in Seattle's residential real estate market?

These are the questions that the Daily Journal of Commerce recently charged me with discussing. So I want to consider the residential markets in aggregate: past, present and future.

For the general public and developers alike, the all consuming question concerning residential, and indeed commercial development, is always relative to value. I scoured our archives and was interested to find that we have seen four periods of depreciation in housing values in our region (excluding our current contraction). These were in the late 1940's, from 1969 to 1975, 1979 to 1985, and from 1990 to 1992.

If history tells us anything it is that commodities, including housing, are prone to cycles that do not necessarily line up with business cycles, but are generally driven by economic recessions. I would note here though that this excludes the current downturn, as well as the 2001 recession that was driven by a plunging stock market wherein the Federal Reserve substantially loosed credit which, ultimately, let to our current downturn. It is my hypothesis that both downturns in home values are intrinsically linked.

When we look at the housing market from an historic perspective, downward pressure on prices has, generally, been very modest over the past five decades. Stability has been maintained, in part, as a function of the ratio between homeowners to renters being very static. In general, average home price gains have matched the inflation rate very closely, with values increasing by an average of 4.4 percent and inflation running at 4.6 percent.

Housing prices reflect local employment and income growth as well as the national interest rate, but economic fundamentals alone cannot explain the extreme fluctuations in real estate values and construction that occurred during the past three years.

So what happened? Two factors can be blamed for the dramatic decline in the housing market. The first was the explosive growth in “subprime” lending that allowed infinitely unqualified people to finance purchases. By 2005 almost a quarter of all loans originated were subprime and the stock of subprime loans had reached 8 percent of total U.S. mortgage debt. The second was the surge in second home buyers (partially attributable to the first factor). In 2005, for example, the U.S. total housing production exceeded household formation by 60 percent! This was clearly unsustainable by any stretch of the imagination.

Ultimately consumers started buying for the sake of buying — and that ultimately led to a run on real estate.

Back in 2001, we were already in a recession and the Federal Reserve had reduced interest rates in an attempt to stabilize the markets following the busting of the technology bubble. Furthermore, following the tragic events of 9/11, President Bush urged consumers to spend in order to keep the economy running. The cuts in rates led to ever cheaper mortgages, home equity loans, automobile financing and other kinds of credit.

Homeownership rates came close to hitting 70 percent when the historic average, from 1965 to 1992, was 64-65 percent. The bubble was, indeed, being inflated but many, including myself, failed to see the severity of the bubble.

So where are we now? According to the Case Shiller Index, values have declined by more than 25 percent from the peak in the three-county region. This has certainly hurt everyone who owns housing. The “reset button” has been pushed relative to house values.

What I find of particular interest is that we appear to be seeing stability in transactional values, which I take as a very positive sign. Transactional prices appear no longer to be in freefall. Sellers are starting to understand that prices have been reset and are, for the better part, acting accordingly.

Certainly, we can attribute some of this stability to government intervention in the form of artificially low interest rates and tax credits, but that is not the complete picture. Seattle's economy appears to be showing signs of life and I expect we will return to job growth before the U.S. as a whole. Although growth will be tepid for some time to come, there will be demand for housing of all types.

That being said, I still have fears for the multifamily housing market, specifically condominiums. Prices rose at an egregious rate for several years and I believe that further reductions in price, specifically in the high rise market, are justified and will occur.

So, what does my crystal ball forecast going forward?

We are in a period of recovery that appears to have legs, however it is fragile and will be protracted. Inventory levels of homes for sale are still high and this excludes the shadow inventory of bank-held houses. I hope the assets owned by financial institutions will not pour onto the market in a torrent, but rather be released in a methodical manner. If this is not the case, then one can feel assured of further compression of values.

We will see recovery from the center out, starting in King County and working its way through the central Puget Sound region. On a year-over-year basis, I think we will see improving transactional values by year's end. The spring market is upon us and expiration of the tax credit, in concert with interest rates that will inevitably rise during the year, should get buyers off the fence.

Prices that have stabilized will likely start to move toward the historic trend of increasing at a little more than inflation across the region, with slightly higher growth rates in areas near job centers.

This has been a very hard last couple of years for everyone involved with real estate, but I am seeing a light at the end of the tunnel and I do not believe that it is an oncoming train.

Matthew Gardner is a land use economist and principal with Gardner Economics. His article "Further Pain Coming in the Multifamily Markets" appeared in the Dec. 10, 2009 DJC.